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"YOLOing the Market": Market Manipulation? Implications for Markets and Financial Stability

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"YOLOing the Market": Market Manipulation? Implications for Markets and Financial Stability[1]

By Maggie Sklar

Since the start of the Covid-19 pandemic in 2020, retail investors have increasingly participated at higher rates in the U.S. equities markets, particularly in day trading and short-term trading. In January 2021, amid a surge of online postings[2] and interest by retail investors who use free trading apps, GameStop stock began moving up and down by billions of dollars a day—resulting in big gains for some investors and billions in losses for others.[3] To the extent the proliferation of free trading democratizes the market, increases the diversity of participants able to participate in the market, and contributes to vibrant and healthy markets, this activity has positive benefits. These recent developments pose new questions for policymakers, such as whether the ability for users to gather together on social media and move the price of a financial product—for reasons unrelated to market news or market fundamentals—is a larger vulnerability, whether this activity fits into tools to prevent or stop market manipulation or not, and if there is a gap in regulatory ways to address such activity.

YOLO stands for "you only live once", and "YOLOing the market" is used here to refer to retail investors putting their savings in financial products based on online postings that express exuberance for certain financial products, which is not tied to market news or fundamentals.[4] Rather, they are investing for "YOLO" and related reasons (such as sending the price "to the moon!" and other excited statements and use of emojis) and/or based on online encouragement from people they do not know. While also referred to now as "meme stocks" or the "gamification of markets," I use the term "YOLOing the market" here instead of these terms because, as discussed below, the conduct and effect on the markets and market integrity may not neatly fit into traditional patterns of manipulating the markets or traditional tools.

Market manipulation can undermine confidence in the markets. In addition, conduct that is not market manipulation from a technical point of view, but is perceived by the public as unfairness, can undermine confidence in the markets. A lack of confidence in markets can have broader implications for financial stability because it hurts investment, liquidity provision, and capital formation. It may also have other effects on the role of confidence in market intermediaries. Moreover, a perception that the markets can move due to individual investors getting together online to move prices – in the largest capital markets in the world – may have longer lasting effects on how investment and capital formation occur going forward if people were to lose trust that asset prices in general have some connection to market

[1] The views expressed herein are those of the author and not necessarily those of the Federal Reserve Bank of Chicago or the Federal Reserve System. This policy discussion paper is not meant to be a comprehensive review of securities law, nor is it legal advice. Moreover, it is not intended to suggest how or who may be the subject of litigation.

[2] "Online" posts referred to in this note include posts on Reddit and other social media, including Twitter and "FinTok" influencers (i.e., financial influencers on TikTok).

[3] See, e.g., https://markets.businessinsider.com/news/stocks/gamestop-short-sellers-billions-losses-reddit-traders-wallstreetbets-rally-gme-2021-2-1030125873.

[4] "YOLOing the market" is not only about GameStop, but includes other stocks that were also promoted in online posts and rose in price, as well as other products such as certain cryptocurrencies where the same happened.

fundamentals. If there were a perception of markets being manipulated, this would also run the risk of impairing the credibility of U.S. markets and financial regulators.

Financial stability is not just about "too big to fail" institutions or the health of the largest banks and non-bank financial market infrastructures. It is also "[not] about preventing failure or stopping people or businesses from making or losing money. It is just helping to create conditions where the system keeps working effectively even with [good or bad] events."[5]

At this point, there is no clear evidence that this recent retail investing activity reaches the level of it being financially systemic. Systemically important and large banks and financial market infrastructure seem to be handling the movements and volatility, and working as expected. However, it is a new risk to be aware of, particularly as it is one that current regulatory tools directed at the firm-level, or enforcement actions based on the usual forms of market manipulation and fraud, may not be equipped to address. These tools may need to be to re-evaluated or revised to comprehensively address "YOLOing the market."

What is "YOLOing the market"?

There is nothing new or necessarily problematic about retail investors (experienced and inexperienced) sharing their thoughts or excitement about stocks online. "YOLOing the market" somehow "feels" different. Perhaps because of the speed of how it has happened, which is facilitated by the online postings and easy electronic trading apps, or by the public nature and openness of the people engaging in it. Or because it appears to have been actually effective in moving the stock price.

The ease of "YOLOing the market" is facilitated by free, easy-to-use trading apps, for example, the Robinhood app, which is popular among retail investors. Robinhood has a layout with relatively minimal market information and uses color coding to make stock momentum readily apparent. Rather than charging commissions or fees per trade, Robinhood makes its money by interest on cash left in user accounts, charging users for premium accounts and leveraged margin trading, and rebates from sending orders to a market maker (also known as payment for order flow). In addition, some online posts from retail investors noted their interest in trading also arises from a variety of circumstances related to the Covid pandemic, including boredom due to closures, working from home, the inability to spend money elsewhere on leisure activities, or the receipt of stimulus checks.

Conceptually, "YOLOing the market" activity could at first glance be reminiscent of traditional market manipulation. For instance, the online promoting activity has some similarities to a classic market manipulation "pump and dump" scheme (e.g., someone promotes a cheap stock to retail investors in online posts by telling them it is going to cure cancer, and that is not true, and they know it is not true). Or an online version of a "boiler room" scheme (e.g., a collective group of people randomly call or email strangers to convince them to invest in a financial product, which is too good to be true, and they know it is too good to be true). To some, it may also appear to be reminiscent of gambling, just by using a trading app instead of a gambling app. But does it fit into these traditional ideas, or is it something new?

[5] Details online, https://www.federalreserve.gov/faqs/what-is-financial-stability.htm#:~:text=The%20Federal%20Reserve%20works%20to%20identify%20threats%20to,and%20also%20conducts%20research%20on%20financial%20stability%20issues.

Capital markets

The U.S. capital markets are the largest in the world and continue to be among the deepest and most liquid. The U.S. stock market is socially useful and beneficial to the U.S. economy, supporting its financial stability. It promotes the efficient use of capital formation and investment, the efficient allocation of resources, and allocates risk efficiently between investors and speculators. Other aspects to well-functioning and efficient markets include the liquidity and accuracy of the markets.

The goal of regulating these markets, in addition to the important goal of investor protection, is to preserve the fairness and efficiency of the markets and reduce systemic risk. The primary regulator of these markets, and the one tasked with investor protection, is the U.S. Securities and Exchange Commission (SEC). Other U.S. financial agencies also have an interest in the stability of these markets, as well as financial markets generally, including the Federal Reserve, U.S. Treasury, as well as collectively through the Financial Stability Oversight Council (FSOC).

Market and price manipulation regulatory tools

U.S. financial regulatory agencies that have anti-manipulation authority have market manipulation statutes and rules that make it unlawful to use or employ any manipulative or deceptive devices or contrivances in connection with a transaction subject to the agency's jurisdiction.[6] In practice, whether trading activity is manipulation is not a bright-line test. It is fact and circumstance dependent, often along the lines of "I know it when I see it."

In a traditional "pump and dump" market manipulation scheme, including ones by individuals posting online, it is not enough to show that there is a price movement based on a statement that promotes the stock. There has to be a showing of fraud, such as that the statement itself is false or misleading, that it was material, and importantly that there was scienter, i.e., an intent to deceive, manipulate, or defraud.

Price manipulation is another unlawful form of manipulation, which prohibits a person, alone or with others, from engaging in securities transactions that raise or lower the price of the security, for the purpose of inducing the purchase or sale of such security by others.[7] In order to show price manipulation, it must be shown that the individual had an ability to influence market prices and caused an artificial price with the intent to do so. Much of the focus is on the manipulative (not necessarily fraudulent) intent of the trader, in addition to whether the price is an artificial price.

The related theory of open market manipulation does not involve fraudulent statements and the stock transactions themselves are transacted permissibly in the market. In this type of scenario, the purchaser buys securities legally, but does so with the purpose to affect the price of the security. In practice, this has wound up being fraud-based (e.g., looking for deceptive practices or false statements) or focused on manipulative intent. Given that, it is not clear whether legally purchasing securities to collectively raise the price of the security is a cause of action in itself based on the conduct and effect on the markets and market integrity, or it requires some other level of intent or other indicia of bad behavior.

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[6] Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j; see also Section 6(c)(1) of the Commodity Exchange Act, 7 U.S.C 9(c).
[7] Section 9(a)(2) of the Securities Exchange Act of 1934, 15 U.S.C. §78i(a)(2).

While many securities market manipulation cases tend to rely on concepts of fraud and intent, there is a question as to whether some of the conduct observed online may be governed by other laws, falling outside of the traditional securities realm. Under antitrust law, conspiring to price fix is prohibited. Although not frequently used in securities law, it has been used before to address securities-related price fixing.

Other regulatory tools

The enforcement tools noted above are an ex-post regulatory approach to addressing market manipulation, and do not generally detect or prevent market manipulation proactively or in real time, although they may serve as deterrent tools. Outside of the enforcement area, regulators have some tools that can be employed during periods of heightened or volatile market activity. These include additional monitoring of the market, investor education campaigns, and communicating with broker dealers about their customers' risk tolerance levels, including their possibly making adjustments, such as limiting their customers' use of leverage. Existing tools for detecting and preventing market manipulation in the derivatives markets, on the other hand, are aimed to some degree at large market participants, such as exchange enforcement of position limits and regular large position reporting that is used to monitor large positions. Other manipulation detection tools used by exchanges and self-regulatory organizations generally include exchange monitoring and reviews, in real time or after, for prohibited trade practices.

Other general tools for preventing misconduct include licensing and registration, reviewing the content and marketing of prospectuses and disclosure documents, protecting whistleblowers, managing conflicts of interest, and setting conduct expectations, among others. These tools are generally aimed at the firm level, and not the individual investor.

Takeaways from GameStop and "YOLOing the market"

Does the recent retail trading of GameStop fit into the traditional ideas of what market manipulation is, if at all? Is the statement "GME to the moon!" fraudulent or manipulative, or merely enthusiastic? What about online postings that offer other investors free pizza or charitable donations in exchange for continuing to engage in the trading? Or encourage them to continue holding on to the stock for non-economic reasons, such as even if the stock price is dropping and they will take a loss? What about posters encouraging revenge trading to get back at "Wall Street" generally or specific hedge funds, or as payback for their losses during the Great Recession? What about posting "GME to 1000!"? Is it possible that some perhaps innocuously (at the time) posts appear manipulative with the benefit of hindsight? Is it also possible that a reasonable person could find that some or many of these statements are not actionable because they are merely expressions of optimism or "mere puffery,"[8] or protected speech?

There is likely not a clear or one-size fits all answer when it comes to addressing the thousands of online posts for this one stock alone. However, it is possible that when put on a sliding scale, one could see differences between a purely optimistic post (such as the use of a rocket ship emoji)—and a lengthy post encouraging others to join in on the trading for a purpose such as personal revenge, or a post offering food or other forms of in-kind compensation to others for continued trading. Nonetheless, a

[8] "Puffery" is a legal term defined by various courts in various ways, but in essence it is an exaggerated claim that is not considered deceptive or misleading, because a reasonable person would know not to rely on it.

traditional fraud-based manipulation claim would likely be a difficult fit, even for many of the optimistic "pump"-like statements.

Moreover, relying more on an open market manipulation, price manipulation, and/or price-fixing theory may be a better way than fraud-based ways to examine these types of comments, particularly given that any harm from "YOLOing the market" may not necessarily be the usual harm to an inexperienced or misled investor, but rather a harm caused by an artificially high price or damage to market integrity generally. In practice, the evidence of an illegal agreement to set or fix a price or conspire is often secretive, and has to be discovered by capturing and examining recordings and reviewing emails and chats and piecing it together. But just because a statement or an alleged agreement is not secretive and is out in the open in online forum comments should not discount its value as showing conduct, collusion, or purpose.[9] Ultimately, whether any of this conduct may fall under one or more of the legal categories mentioned above is highly fact dependent, and the outcome will depend on the interpretation of the courts, if any legal cases are ever brought before the courts.

In addition, there may be a role for other ex-ante tools. Besides enforcement, there are other steps regulators can take to acknowledge the new role of retail investors while minimizing the risk of systemic impact of this conduct – for example, strengthening exchange or broker-dealer self-regulation or oversight on sharp market moves untied to market fundamentals. There is already a precedent with this with required exchange halts and pauses, which were used by the exchange on the GameStop stock several times. Broker-dealers may consider additional measures, such as examining social media activity in real time in stocks heavily traded on their platforms, additional on-screen reminders to an investor before they hit the "buy" button on a stock experiencing high volatility, or limiting leverage on individual stocks being actively promoted online without ties to market fundamentals. In addition, suitability requirements for retail investors could be re-examined. Or a consideration of suitability requirements for apps that appear to gamify trading.

Although an extreme measure, the regulator can also stop trading in a product where there is volatility that may be related to fraud and manipulation. The SEC has done this before in suspected schemes, although the promoter of the stock in those cases tended to have ownership or affiliation with the company in question. In addition, other ideas could be considered, such as subjecting online investment chat forums to registration with the financial regulator, or registering online financial influencers.

Other traditional regulatory tools, such as increased advisories aimed at retail investors, may be less effective in some ways here—in that it is practically unlikely that many of the same retail traders posting their "YOLOing" messages online and trading based on others' posts are going to read a notice about investor education on a government website and change their behavior. More creative, and more social-media savvy educational approaches, and even educational counter-approaches to the information shared in online posts, may be needed. Relatedly, another traditional regulatory tool, enhanced disclosures by the issuer or broker-dealer may also not be effective where traders are not interested in trading based on what is or is not said by the issuer or contained in the disclosures, but are intentionally trading unrelated to market fundamentals and based on online posts.

[9] Even in more traditional market manipulation cases, traders often do not say in their emails or private chats statements such as "Hey, let's violate Section 10(b) or Section 9(a)(2) of the Securities Exchange Act today!"

Further, and although there is less retail participation in the futures markets and it is not quite an exact fit, safeguards in the derivatives markets may also serve as a potential example in whether the exchange and/or exchange's intermediaries monitoring responsibilities, including for financial resources (i.e., margin and ability to meet margin calls), position limits and position accountability levels, and ability to meet (or not) physical delivery (perhaps a corollary could be standards on allowing leverage), could potentially apply or be used in some fashion in the equities market.

Finally, other more restrictive considerations could include market structure changes to limit "YOLOing the market," but these could have substantial costs that would make them inadvisable for other reasons. For example, if payment for order flow was curtailed, or retail investors paid a commission per trade, it would disincentivize short-term trading of small amounts of relatively cheap equities, in essence requiring more "skin in the game" by retail investors before purchasing. There are other more restrictive possibilities as well, but these all have clear downsides in making market participation more expensive.

Conclusion

Like other laws and rules that have been or are being re-reviewed due to changes in technology, such as exchange fee structures, the use of cryptocurrencies, and not requiring the use of older technology like faxes, existing laws and rules may need to be reviewed given the growing role of free retail trading apps and online posts on encouraging certain forms of trading. Additional law, rules, or guidance could protect market integrity and confidence in the markets when people may get together online to prop up a price for purposes other than market fundamentals or market news with the intent of "YOLOing the market."

The potential approaches mentioned are all meant to be considerations and not specific recommendations. Any of these types of policy changes have costs, which would need to be weighed against the benefits.